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COMMENTARY ON THE DRAFT REGULATIONS ON ACCOUNTING PRINCIPLES AND PROCEDURES (LOS/PCN/SCN.3/WP.6/Add.7)

(Prepared by the Secretariat)

Introductory note

1. As indicated in the introductory note to the working paper by the Secretariat, 1/ these draft regulations are based on the accounting procedures used by several of the largest petroleum companies engaged in offshore petroleum production in a number of countries in Africa, Asia and South America, as well as a model form prepared by the United Nations Centre on Transnational Corporations (UNCTC) for the offshore petroleum operations of a large Asian country in 1981 ("the 1981 UNCTC Model Accounting Procedure"). It was considered that offshore petroleum operations offer the best available model for use in offshore mining operations at this time.

2. As also indicated in the introductory note, the draft attempts to balance the requirement for uniformity in accounting and reporting with flexibility to enable each contractor to establish its own accounting manual and chart of accounts, which are subject to approval of the Authority, so that the detailed accounting procedures used would best fit its own operations and be consistent with the accounting requirements of its own independent auditors and with applicable national legislation. This is in keeping with the offshore petroleum industry practice where the accounting procedure is usually found as an annex to the basic agreement between a Government and a petroleum company.

1/ LOS/PCN/SCN.3/WP.6/Add.7.

3. The draft regulations are entirely consistent with the Conclusions on Accounting and Reporting by Transnational Corporations 2/ of the UNCTC Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR).

4. The draft regulations are also consistent with the International Accounting Standards as of 1 January 1990 of the International Accounting Standards Committee (IASC). The IASC "formulates and publishes, in the public interest, accounting standards to be used in the presentation of financial statements. It has the world-wide support and involvement of the accountancy profession, financial analysts, the business community, trade unions, securities regulators and stock exchanges. It also works closely with national standard-setting bodies and intergovernmental organizations". 3/ IASC has member bodies in over 70 countries and its board meets regularly with an International Consolidated Group which includes the representatives from the International Finance Corporation, the World Bank and an observer from UNCTC. It should be recalled that annex III, article 13(9)(b) states that the Authority "shall, in its rules, regulations and procedures, specify uniform and internationally acceptable accounting rules and procedures ..." The IASC International Accounting Standards are such accounting rules and procedures.

5. The Accounting Principles and Procedures apply to contractors and to the Enterprise.

Commentary

Article 2

Use of terms

The term "Accounting Manual" is defined in paragraph 1. Each manual will be proposed by a contractor for its internal purposes and will contain detailed instructions for the recording of transactions, the internal control procedures, the chart of accounts (the different headings or categories under which transactions are recorded) and the preparation of analyses and financial reports. Each manual is to be approved by the Authority. The result will be that each contractor will have an accounting manual which differs from the others as best suits its own accounting practices. However, the accounting principles used will be those set out in the regulations in conformity with the generally recognized accounting principles referred to in article 138 of these draft regulations.

2/ United Nations publication, sales No.E.88.II.A.18. Hereinafter cited as "ISAR Conclusions".

3/ "International Accounting Standards 1990", International Accounting Standards Committee, 41 Kingsway, London WC2 B6YU, p. 9. Hereinafter cited as "IAS 1990".

"Accounting records" is defined in paragraph 2 quite broadly to include not just the books of account, but all supporting documents, analyses, working papers and reports, so as to allow inspection and audit of all such documentation under article 155, paragraph 2, of of these draft regulations.

"Controllable materials" is defined so that detailed records need not be kept for materials that are not of significant importance (low-value materials, for example, such as screws and nuts). The guidelines for that determination are to be found in the classification section of the Accounting Manual which must be in accordance with international accounting industry practice.

Article 137

Scope of this Part

Annex III, article 17(1)(c)(i) requires that the Authority adapt and uniformly apply rules, regulations and procedures for, inter alia, the "establishment of uniform and non-discriminatory costing and accounting rules". As a consequence, the regulations must apply to the recording of all of the financial transactions of contractors and provide a uniform system of standards for the handling of funds, materials and equipment.

It is also necessary to have a uniform system for the preparation of the reports required by the regulations and the contracts to ensure the comparability of financial statements. 4/ Such comparability is necessary for the Authority to properly supervise operations as required by annex III, article 17(1)(b)(viii) and, as pointed out in paragraph 4 of the introductory note to the working paper by the Secretariat, in order "to ensure equality of financial treatment and comparable financial obligations for contractors" under annex III, article 13(1)(c).

Needless to say, these regulations are required "to ensure optimum revenues for the Authority from the proceeds of commercial production" under annex III, article 13(1)(a).

4/ See ISAR Conclusions, para. 21, p. 7.

Article 138

Accounting principles

Paragraph 1

This paragraph requires that all of a contractor's "costs and expenditures ... be reasonable and necessary, consistent with efficient and economical operations". The word "necessary" is found in the definition of "contractor's development costs" in annex III, article 13(6)(h)(ii). "[T]he efficient conduct of activities in the Area" and "the avoidance of unnecessary waste" are requirements of article 150, subparagraph (b), of the Convention. The 1981 UNCTC Model Accounting Procedure required that "expenses must be necessary and proper costs to conduct the petroleum operations and the amount of such expenses must be fair and reasonable". These, of course, are "in accordance with sound commercial principles" with which the Enterprise is required to operate in accordance with annex IV, article 1, paragraph 3, which has a general applicability.

Paragraph 2

The reference to "generally recognized accounting principles" is found in several of the provisions of annex III. 5/ The phrase "consistent with practices accepted in the international mining industry" has been included in order to expand on the phrase "internationally acceptable accounting rules and procedures" in annex III, article 13(9)(b) and in order to ensure "comparability". ISAR "agreed that accounting standards should comprise, where appropriate, comparable elements". 6/ "Comparability" is also stressed by ISAR 7/ and by IASC 8/ as one of the qualitative characteristics of financial statements.

While over time it is expected that there will be a sufficient number of deep seabed mining operations to allow for comparability in financial reporting, at the beginning it will be necessary to compare deep seabed mining with the practices of the international mining industry and the offshore petroleum industry.

5/ A3/13(6)(h)(i), (k), (l), (n)(iv) and (v), (7)(b), (11).

6/ ISAR Conclusions, para. 21, p. 7.

7/ ISAR Conclusions, para. 75 (e), p. 23.

8/ IAS 1990, paras. 39-42, p. 39.

Paragraph 3

This paragraph is based on annex III, article 13(9)(b) which mentions UNCTC and "other international organizations", and refers to "internationally acceptable accounting rules and procedures". The latter reference would include the ISAR Conclusions and the IASC International Accounting Standards.

Article 139

Currencies

Paragraph 1

One currency is necessary in order to avoid exchange rate fluctuations which would impede "comparability", discussed above under articles 137 and 138. The United States dollar has been chosen as the unit of account consistent with objective 1 (c) of annex III, article 13. As stated in footnote 19 to the Draft Financial Terms of Contract, part VI of the regulations, 9/ since that objective seeks to ensure equality of financial treatment, all calculations should be in one common currency. Exchange rate changes will otherwise distort comparative financial performance. The United States dollar was chosen as the unit of account for fees in annex III, article 13(2) and (3) and the minimum expenditure requirements in resolution II, paragraph 1 (a) (i) are also fixed in United States dollars. It is the currency in which most goods are primarily quoted and metals traded on international markets. Since annex III, article 13(13) requires adjustments for inflation, the United States Wholesale Price Index was used as it measures a broader category of goods than most other indexes.

The provision for the translation of other currencies into United States dollars is consistent with article 80(82), paragraph 1, of the Draft Financial Terms of Contract, Part VI of the regulations. 10/

Paragraph 2

The recognition of foreign currency gains or losses in a separate account is in accordance with chapter V, paragraphs 67-71, of the ISAR Conclusions, 11/ and international accounting standard 21, "Accounting for the effects of changes in foreign exchange rates". 12/

9/ LOS/PCN/SCN.3/WP.6/Add.2, p. 6.

10/ LOS/PCN/SCN.3/WP.6/Add.2, Rev.1, p. 11.

11/ ISAR Conclusions, pp. 20 and 21.

12/ IAS 1990, pp. 274-286.

Article 140

Accounts and manuals

Paragraph 1

The Accounting Manual and comprehensive chart of accounts sets up the detailed accounting system that is to be followed by the contractor's bookkeepers. As discussed under article 2 above, permitting each contractor to propose a chart of accounts and its own accounting manual will enable each contractor to determine the detailed accounting procedures which best fit its own operations and are consistent with the accounting requirements of its own independent auditors and applicable national legislation. This is the usual practice in the offshore petroleum industry. Again, the chart of accounts and the Accounting Manual must be approved by the Authority.

While the Authority could at the outset prescribe an accounting manual and chart of accounts for all contractors, including the Enterprise, it is suggested that this might be too rigid an approach, especially in the absence of experience, though it is possible that after experience is accumulated the Authority might wish to do that in order to ensure effective comparability.

Paragraph 2

It is important to require that a complete set of books of account be kept at a particular place in order to ensure that the accountants will be able to carry out auditing in compliance with the regulations. This does not preclude contractors from maintaining duplicate sets of books of account in places that may be of convenience to them. Such arrangements are not uncommon, particularly in the current era of computerization. It should be expected that books of account will probably be completely computerized, but tapes and hard copies or printouts would have to be made available at a contractor's principal place of business in accordance with this paragraph.

Article 141

Accounting for materials and supplies

Paragraph 1

This paragraph provides that materials and supplies purchased solely for the use in the contractor's operations shall be charged at actual cost at the point of use or location. This provision uses the historical cost basis of international accounting standard 2. 13/

13/ IAS 1990, pp. 67-75. See also ISAR Conclusions, paras. 99-106, pp. 28 and 29.

Paragraph 2

This paragraph deals with materials and supplies from the contractor's stocks and not specially purchased for the contractor's operations under the contract (which is covered in paragraph 1). Such material and supplies are divided into three categories: conditions A, B and C. Condition A refers to new material which is priced on the same basis as provided in paragraph 1 of this article for purchases made solely for use in the contractor's operations under its contract. Condition-A new material is priced at historical cost plus the costs of making the material suitable for use and moving it to the location where it will be used.

Material which is not new but is used (second-hand or "pre-owned") is divided into two categories: condition B, which is sound and serviceable without reconditioning; and condition C, which requires reconditioning. In keeping with the accounting practice of the offshore petroleum industry, condition B material is priced at 75 per cent of historical cost, and condition C material at 50 per cent historical cost. The same figures were used in the 1981 UNCTC Model Accounting Procedure.

Other material which is not classifiable as condition A, B or C (not of any great value) is priced at a value commensurate with its use, and this was also the formula used in the 1981 UNCTC Model Accounting Procedure.

Paragraph 3

This paragraph, requiring the keeping of perpetual accounting records of controllable materials, allows for the conduct of the physical inventory necessary for auditing. These accounting records must cover materials transferred into and out of warehouses and material in inventory. Note that the materials covered here are the "controllable materials" as defined in paragraph 3 of article 2.

Paragraph 4

The problem dealt with here is how to price materials which may be purchased at different times and may not be distinguishable; for example, is a particular part one for which $100 or $150 was paid? For accounting purposes, a number of generally accepted cash flow assumptions can be made for controllable material, where it may be difficult or expensive to specifically identify items of inventory which are ordinarily interchangeable, such as:

(a) first-in, first-out (FIFO);

(b) last-in, first-out (LIFO);

(c) next-in, first-out (NIFO);

(d) weighted average cost; and

(e) latest purchase price.

While the method selected for the purpose of assigning costs may have widely different effects in any given accounting period, any method if used consistently during the life of the contract (as provided in this paragraph) should, over the life of the contract, have financial results which would not be appreciably different from any other method. Of course, a method could be changed from time to time so as to manipulate costs, but that is provided against in paragraph 4 by requiring that the method selected cannot be changed without the consent of the Authority. 14/

Paragraph 5

This paragraph specifically permits the contractor, through the Accounting Manual, to choose a cash flow assumption or method for computing the unit cost of controllable materials, subject to paragraphs 2 and 4 of the article. Again, this provides a degree of flexibility to contractors, but the method must be consistently used during the life of the contract.

Paragraph 6

The Authority may require that each contractor furnish reports and lists all of the controllable material in inventory. This too will allow for auditing and verification. The same provision is found in the 1981 UNCTC Model Accounting Procedure.

Paragraph 7

It is a common requirement that a physical inventory be conducted of the controllable materials once a year. The same requirement was contained in the 1981 UNCTC Model Accounting Procedure.

Paragraph 8

This paragraph provides a mechanism for the Authority and the accountants to participate in each physical inventory. The same requirement was contained in the 1981 UNCTC Model Accounting Procedure.

14/ See international accounting standard 2, especially paragraphs 13 and 14 and the discussion in paragraphs 13-15 of the Explanation, IAS 1990, p. 71. Paragraph 102 of the ISAR Conclusions, p. 29, requires that the method selected "most clearly [reflect] the economic reality of the situation" so that it "permits a true and fair view of the results of operations". The ISAR Conclusions also stress that "the method adopted should be consistently applied from period to period and adequately disclosed in the financial statements."

Paragraph 9

It follows that any "significant" discrepancy from the inventory records and the physical inventory should be accounted for and explained as required by this paragraph. Such an accounting and explanation is to be submitted in a report to the Authority for approval. "Significant" is defined as "any total inventory adjustment exceeding 1 per cent of the total dollar value of inventory before adjustment." The 1 per cent figure was recommended by specialists with experience in accounting for offshore petroleum operations in one of the six largest international accounting firms.

Article 142

Accounting for equipment

Paragraph 1

This article deals with accounting for equipment which is capitalized as a physical asset. This paragraph parallels paragraph 1 of article 141 in providing that equipment purchased by the contractor shall be charged on the same basis as materials and supplies, i.e., at invoice price, less all discounts and rebates, plus actual costs including freight, insurance, duties, fees, handling charges and other costs actually paid to the point of use.

Again, the historical cost basis is used. 15/

Paragraph 2

As a consequence, paragraph 2 requires a physical inventory of the capitalized physical assets every five years, or earlier at the request of the Authority. 16/ It is a normal accounting practice to conduct a physical inventory, that is, an examination of the assets listed in the inventory, to confirm that they are really there. This is necessary to justify the depreciation charges. It would be improper to charge depreciation for assets which were not physically present.

15/ See the footnote under paragraph 1 of article 141 above.

16/ As the accountants are required, inter alia, by paragraph 6 of article 80(82) of the Draft Regulations Concerning the Financial Terms of Contract, part VI of the regulations, to verify the calculations of the Authority's share of the attributable net proceeds each year, the verification of the physical inventory by the accountants would ordinarily be a prerequisite for such verification. The accountants might require physical inventories more frequently than at five-year intervals. This parallels paragraph 8 of article 141.

Paragraph 3

This paragraph, requiring that notice of each physical inventory be given to the Authority and the accountants at least 60 days in advance, is necessary in order to allow the Authority to supervise operations properly. 17/

Paragraph 4

Again, as in the parallel paragraph 9 of article 141, it follows that any significant discrepancy from the inventory records and the physical inventory should be accounted for and explained. The accounting and explanation are to be submitted in a report to the Authority for approval if the gain or loss is "significant". As in article 141, paragraph 9, "significant" is defined as "any total inventory adjustment exceeding 1 per cent of the total dollar value of physical assets before adjustment".

Article 143

Personnel costs

Paragraph 1

This paragraph deals with direct personnel costs and expands on the phrase "wages, salaries, employee benefits" found in the definition of "contractor's operating costs" in annex III, article 13(6)(k). The paragraph makes it clear that gross salaries are included in such costs as well as bonuses and premiums. In addition, for the avoidance of doubt, the assessments or obligations applicable to such costs imposed by Governments (such as social security payments) are also specifically included as personnel costs.

Paragraph 2

Similarly, the "benefits" referred to in the definition in annex III, article 13(6)(k), are expanded in this paragraph to include holiday, vacation, sickness and disability payments, as well as life and medical insurance and pension and savings plan contributions, which are to be charged in accordance with the Accounting Manual in order to provide the requisite flexibility. Each contractor will probably have different benefits in accordance with its Group practices. While not wishing to dictate complete uniformity in this regard, control is exercised through the Authority's approval of the Accounting Manual.

17/ A3/17(1)(b)(viii).

Paragraph 3

The same comments apply to this paragraph which deals with travel and subsistence costs which are again to be charged in accordance with the standards and procedures of the Accounting Manual for the reasons specified in the previous paragraphs.

Article 144

Charges for training programmes

This article covers the costs of training programmes for the personnel of the Authority and developing States as required by annex III, article 15.

Article 145

Charges for transfer of data

Similarly, annex III, article 14, requires the transfer of data by the contractor to the Authority; the costs thereof are provided for in this article.

The word "necessary" is found in the definition of "contractor's development costs" in annex III, article 13(6)(h)(ii).

Article 146

Charges for third-party contracts

The direct costs of contracts for technical and other services supplied by third parties are covered by this article. Such costs must be "reasonable and necessary and not higher than those generally charged for comparable work and services." In the 1981 UNCTC Model Accounting Procedure, such charges must be "necessary and proper costs" of conducting operations and "the amount of such expenses must be fair and reasonable". The use of the word "comparable" parallels the discussion of "comparability" in paragraphs 39-42 in the International Accounting Standards Framework. 18/ This is a factor in the selection and application of appropriate accounting policies which was also cited in paragraph 75 (d) of the ISAR Conclusions. 19/ To be comparable, prices must be free market or arm's length. Annex III, article 13(9)(a), states that "determinations of price and value ... shall be the result of free market or arm's length transactions."

18/ IAS 1990, p. 39.

19/ ISAR Conclusions, p. 23.

Article 147

Charges for affiliates

This article deals with transfer pricing, the charges made for transactions between related parties. The definition of related parties found in this article is a fairly common one, which depends on the control of one party by another party. As stated by ISAR, "parties are considered to be related if one party has the ability to control the other party or exercise significant influence over that party in making financial and operating decisions, or if the parties share a common parent." 20/ International accounting standard 24 deals with related party transactions and "parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions." 21/ Control is defined to include "ownership, directly or indirectly through subsidiaries, of more than one half of the voting power of an enterprise, or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise." 22/ The definition of control is also discussed in paragraph 45 of the ISAR Conclusions. 23/

The arm's length standard is universally used. It is found in annex III, article 13(9)(a) and (b). The term is used in explanation paragraph 11 of international accounting standard 24. 24/ It is also used in article 81(83), the Draft Financial Terms of Contract, part VI of the regulations. 25/

Article 148

Rental payments

This article provides that any financing charges that are included in rental payments can only be charged to the extent that the present value of the capitalized lease obligations are included in the debt-equity ratio which the Authority has approved, and that the rates of interest have been found reasonable by the Authority, having regard to existing commercial practice, as

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20/ ISAR Conclusions, para. 158, p. 42.

21/ IAS 1990, p. 315.

22/ Ibid.

23/ ISAR Conclusions, pp. 13 and 14.

24/ IAS 1990, p. 318.

25/ LOS/PCN/SCN.3/WP.6/Add.2, Rev.1, pp. 12 and 13.

required by annex III, article 13(6)(o). This is in accordance with article 78 (80), Draft Financial Terms of Contract, part VI of the regulations. To do otherwise would allow a contractor to evade those debt-equity limitations and interest restrictions.

Article 149

Insurance costs and losses

This article permits a contractor to charge the net premiums for insurance and the deductible portion of insured losses as well as losses not covered by insurance. This is normal practice and a similar provision is found in the 1981 UNCTC Draft Accounting Procedure.

However, losses resulting from a contractor's gross negligence or wilful misconduct may not be charged. Article 150, subparagraph (b), of the Convention requires "the efficient conduct of activities in the Area" and "the avoidance of unnecessary waste". Such costs cannot be said to be "directly related to the mining of the resource and the area covered by the contract" as required by annex III, article 13(6)(n)(iii)-(v). To permit costs attributable to the contractor's gross negligence or wilful misconduct to be charged would result in those costs being borne in part by the Authority through the diminution of its share of attributable net proceeds. Such costs cannot be said to be "reasonable and necessary, consistent with efficient and economical operations" as required in paragraph 1 of article 138 of these draft regulations. Nor can such costs be in accordance with "normal business practice" which is part of the definition of "development costs" and "development costs of the mining sector" in article 2, paragraphs 5 (a) (i) and 6, Draft Financial Terms of Contract, part VI of the regulations.

Article 150

Legal costs are to be charged to the extent that they are necessary or expedient for the protection of the contractor's interests. These costs must be part of the "contractor's development costs of the mining sector" or "contractor's operating costs" as required by annex III, article 13(6). Since the contractor did not have any interests to be protected under the contract before its effective date, no costs before that date can be recognized. The costs must be fair and reasonable, for unfair and unreasonable legal fees would reduce the revenues of the Authority from the proceeds of commercial production contrary to annex III, article 13(1)(a) which requires that, inter alia, regulations ensure optimum revenues for the Authority.

Article 151

Overhead and administrative costs

Paragraph 1

For the purposes of this article, overhead and administrative costs have been divided. Administrative costs which can be readily determined are covered in paragraph 1. These costs can be determined because they have been incurred specifically and solely for operations under the contract and are covered by the definition "development costs" and "operating costs". The administrative costs which cannot be so determined are covered by paragraph 2.

Paragraph 2

Indirect costs which are not solely and specifically related to operations, but may be only in part related to operations under a contract and in part related to other operations, are covered by this paragraph. In keeping with the usual practice of the offshore petroleum sector, and in accordance with the 1981 UNCTC Draft Model Accounting Procedure, such overhead costs are to be charged as a percentage of development costs and a percentage of operating costs, respectively, which are to be agreed by the contractor with the Authority. This obviates the commercially impracticable keeping of detailed records and the allocation of charges, which are extremely difficult and costly to ascertain.

It is not uncommon to have such percentages negotiated on a sliding scale so that, as the size of the operation increases, the overhead percentage decreases due to the usual efficiencies of scale. To use a simple analogy: the indirect overhead costs of an airline with 100 planes would be proportionately less than that required to operate an airline with only one plane.

Paragraph 3

This paragraph covers technical employees directly employed in operations under the contract. It is relatively cost-efficient to keep track of the time they spend on a particular contract so that their salaries, wages and expenses can be charged directly and are not to be included in the percentage overhead costs provided in paragraph 2.

Paragraph 4

The overhead costs in the case of an emergency or catastrophe are normally treated on a different basis, as in the 1981 UNCTC Draft Model Accounting Procedure. These rates are also to be agreed between the contractor and the Authority.

Again, such costs cannot be charged if they are a consequence of a contractor's negligence or failure to use good mining industry practice. This

is a proviso usually found in a definition of force majeure, i.e., an event which ordinarily would excuse non-performance because it results from a cause which is beyond a contractor's reasonable ability to prevent or control. Provision is made in this paragraph as well for percentages on a sliding scale as is the practice in the offshore petroleum industry and as was provided in the 1981 UNCTC Draft Model Accounting Procedure.

Paragraph 5

This paragraph allows the contractor and the Authority to amend the agreed-upon overhead percentages, if in practice the ratios are found to be excessive or insufficient. It may be that the Authority will provide for agreed-upon overhead ratios to apply for a specified period of time to ensure that both parties will benefit from experience.

Article 152

Credits

This is a straightforward technical article which requires that accounts be credited with:

Subparagraph (a): the proceeds of insurance, where the premiums paid for such insurance have been charged to accounts under the contract;

Subparagraph (b): revenue received from third parties for the use of assets which have been charged to the accounts;

Subparagraph (c): payments received as adjustments from suppliers and manufacturers for defective material which was charged to the accounts; and

Subparagraph (d): rentals, refunds and other credits received applicable to any charge made to the accounts.

Article 153

Duplication of costs, charges and credits

This is another straightforward technical article which prohibits any duplication of costs and charges by the contractor on the one hand and credits to the Authority on the other.

Article 154

Financial reports

Paragraph 1

This paragraph requires the preparation and submission of quarterly and annual financial reports. Financial reports (sometimes called financial statements) are essential for the Authority to carry out its obligation to supervise operations of contractors under annex III, article 17(1)(b)(viii), its obligation to ensure the receipt of "optimum revenues" under annex III, article 13(1)(a), and, of course, essential for comparability so that the Authority may "ensure equality of financial treatment and comparable financial obligations for contractors", as required by annex III, article 13(1)(c). It is the universal practice to require annual financial reports. (See the discussion of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting in the ISAR Conclusions, paragraphs 23-30, 26/ as well as that in the IAS Framework to the International Accounting Standards, paragraphs 1-21. 27/)

Depending upon the needs of the recipients, quarterly or monthly financial reports are also usually required. In the 1981 UNCTC Model Accounting Procedure, monthly and annual reports were required. While monthly reports would be useful, particularly where it is intended to have comparatively close supervision of the contractor's activities in the Area, the usual practice for financial purposes is to require quarterly and annual financial reports.

Paragraph 2

This paragraph specifies the particular reports which are to be submitted. These include the universally required balance sheet and profit-and-loss statement. The balance sheet presents a financial picture of a contractor at a particular date. The profit-and-loss statement shows the financial results of operations over a particular period.

Paragraph 2 also requires the preparation and submission of a statement of sources and use of funds, 28/ which is a requirement of international accounting standard 7. 29/ This report summarizes the cash flow during a

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26/ ISAR Conclusions, pp. 9 and 10.

27/ IAS 1990, pp. 28-34.

28/ ISAR Conclusions, paras. 150-152, p. 40.

29/ IAS 1990, pp. 95-101.

period. It shows the internally generated funds from the operations and the funds obtained from external sources. It also shows the use to which those funds have been applied. This differs from the profit-and-loss statement because the report is not concerned with establishing whether the operations resulted in a profit or loss, but only with showing the flow of cash into the operation and out of the operation. Such a report "is useful to improve the understanding of the operations and activities of an Enterprise for the reporting period". 30/

The counterpart to a cash flow statement is a schedule of accrued accounts receivable and payable, which is also required by this paragraph. Where cash flow statements show the cash going in and the cash going out, they do not indicate what bills have to be paid and what receipts can be anticipated, because they are on a cash basis only. As a consequence, the requirement for the inclusion of a schedule of accrued accounts receivable and payable was included at the suggestion of the specialists with experience in accounting for offshore petroleum operations in one of the largest international accounting firms.

These specialists also suggested that each annual report be required to include an analysis of physical inventory gains and losses, as is provided in this paragraph.

Finally, paragraph 2 requires that each annual report be accompanied by a projected or forecast budget profit-and-loss statement for the following year. This too was suggested by the specialists in the international accounting firm. It will enable the Authority to anticipate the financial results of operations and hence its revenues which are necessary for its own scheduling and planning purposes.

Paragraph 3

The form and contents of reports are to be prescribed by the Authority. This should ensure the comparability of such reports, not only with previous reports submitted by the same contractor, but with the reports submitted by other contractors. This is necessary "to ensure equality of financial treatment and comparable financial obligations for contractors" required by annex III, article 13(1)(c), and to enable the Authority to properly discharge its obligations to supervise operations under annex III, article 17(1)(b)(viii). 31/ At the same time, flexibility is provided because, to the extent that the Authority does not prescribe the form and contents of the reports, each contractor will be able to select its own in accordance with the Accounting Manual (which, of course, is subject to the Authority's approval).

30/ Paragraph 2 of the Explanation for International Accounting Standard 7, IAS 1990, p. 97.

31/ See the discussion of comparability under draft article 137 above.

Paragraph 4

This paragraph requires that each report submitted by a contractor to the Authority shall "give a true and fair view" of the financial position, performance and changes in financial position. Paragraph 38 of the ISAR Conclusions 32/ states that financial statements should contain adequate information giving "a true and fair view". Other formulas have been used, notably "presenting fairly", or sometimes "a full and accurate" accounting report. This matter is discussed by IASC in paragraph 46 of the Framework: 33/ "financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in a financial position of an Enterprise".

Paragraph 5

Quarterly reports are required to be sent to the Authority within 45 days after the end of each quarter, in accordance with the recommendation of the specialists in the international accounting firm.

Paragraph 6

Annual reports are required to be sent within 60 days after the end of each calendar year.

It should be noted that the time period for submitting the calculation of the Authority's share of attributable net proceeds each year is within 60 days after the end of each accounting year, in accordance with article 80(82), paragraph 4, of the Draft Financial Terms of Contract, part VI of the regulations. The 60-day requirement has been used here as well. In order to prepare the calculations, it will be necessary to have first prepared at least the profit-and-loss statement.

Paragraph 7

This paragraph provides that the Authority may make comments and propose adjustments to any financial report within the specified time-limits. These comments and proposed adjustments, of course, would have to be considered by the accountants. This also focuses on the importance of receiving quarterly reports so that timely comments and proposed adjustments might be made.

In the event that the Authority does disagree with any financial report, its comments and proposed adjustments offer the basis for discussions to resolve any such disagreement. In the event such resolution does not prove possible, then the comments and proposed adjustments would provide the basis

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32/ ISAR Conclusions, p. 12; see also ibid., para. 15, p. 6.

33/ IAS 1990, p. 40.

for a dispute which would be submitted to binding commercial arbitration, unless both parties agree to settle the dispute by other means, in accordance with article 188, paragraph 2, of the Convention. 34/

Paragraph 8

This paragraph is technical and provides for the finality of reports, but for adjustments from physical inventories (which may be made in the case of capitalized physical assets every five years, in accordance with paragraph 2 of article 142) and audits conducted by the accountants.

Article 155

Inspection and audit

Paragraph 1

An annual audit is required by this paragraph to be carried out by the accountants who are to be selected by a contractor from a list maintained by the Authority in accordance with article 85 of the Draft Financial Terms of Contract, part VI of the regulations. This paragraph also allows the Authority to request additional audits, but any such audits would be at the Authority's expense.

Paragraph 2

This paragraph empowers the accountants selected by a contractor to have access to all accounting records for examination and verification, and authorizes the accountants to copy or make extracts from the documents, correspondence or records which are reasonably necessary for the audit and verification. The provision which allows the accountants to confer with third parties, including those referred to in draft article 147 (Charges for affiliates) was suggested by the specialists in the international accounting firm, and would appear necessary to ensure that the charges made by affiliates were on the basis of the arm's length prices required by that article.

Paragraph 3

In order to carry out an audit properly, the accountants should have to have the right to visit and inspect the various installations, facilities, etc., used by the contractor. The facilities used by affiliates or third parties are included by the reference to such places "directly or indirectly used in connection with the contract".

34/ See article 87 of the Draft Financial Terms of Contract, part VI of the regulations.

Paragraph 4

To ensure the effectiveness of such an audit and to avoid mistakes or misunderstandings, this paragraph requires the contractor to instruct its employees, agents and representatives to cooperate with the accountants and provide explanations to any relevant questions and requests made by those accountants in the course of their examination and verification. This will ensure the efficiency of the audit and avoid needless disputes and misunderstandings.

Paragraph 5

This paragraph gives the Authority the right to designate personnel to participate in such audits to ensure that the Authority understands the financial reports, which should limit the number of comments and adjustments which the Authority might otherwise make pursuant to draft article 154, paragraph 7, and also help to avoid misunderstandings and disputes.

Paragraph 6

This paragraph makes it clear that the audits are to be carried out in a reasonable manner, but it must be recognized that any audit is an inconvenience. Therefore, this paragraph places the burden on the accountants to make every reasonable effort to minimize such inconvenience.

Paragraph 7

This paragraph requires that the annual audit be completed within 120 days from the end of each calendar year, in accordance with the recommendation of the specialists in the international accounting firm.

Article 156

Retention of books, records and documents

As the Authority has the right under paragraph 7 of draft article 154 to make comments and propose adjustments within five years of the date of submission of an annual report, and the parties may then disagree and require time to resolve any such disagreement, this paragraph requires that the books, records and documents referred to in article 155 must be maintained for not less than seven years from the date of issue of the relevant financial report. The seven-year provision is the usual record retention provision in common law jurisdictions. It was also the time period recommended by the specialists in the international accounting firm.

Paragraph 2

Obviously, if there is a dispute which is not resolved within the seven-year period, this paragraph requires that the documentation must be maintained until the matter has been finally resolved, which may, of course, involve arbitration in accordance with the dispute mechanisms referred to above under paragraph 7 of article 154.

Article 157

This article makes the accounting regulations applicable to the Enterprise to the same extent (mutatis mutandis) as the contractors. This will allow the performance of the Authority to be compared to that of the contractors in order to ensure that the Enterprise will "operate in accordance with sound commercial principles" as required by annex IV, article 1, paragraph 3.